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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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OCT - 7 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Implementation of Sections of The Cable Television Consumer Protection and Competition Act of 1992	)	MM Dkt. No. 92-266
	)	
Rate Regulation	)	

REPLY COMMENTS OF JOINT PARTIES

Cablevision Industries Corporation
Comcast Corporation
Cox Cable Communications,
a division of Cox Communications, Inc.
First Carolina Communications, Inc.
Jones Intercable, Inc.
Marcus Cable Company, L.P.
Vista Communications, Inc.

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October 7, 1993

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SUMMARY

Methodology for Adding and Deleting Channels. Using the benchmark tables to adjust overall per-channel rates would result in rates too low to enable systems to recover their costs plus a reasonable profit. Some commenters argue that the benchmarks already include the full costs of upgrades. This, however, is not the case. First, the rates reported in the survey (rates as of September 30, 1992), upon which the benchmarks are based, were not established with the expectation that future increases would be limited to the rate of inflation. Had the current price cap approach, which does limit increases to inflation, been in place, the rates would have had to be higher in order to recover upgrade costs.

Second, the benchmark rates are not based solely on the rates of recently upgraded systems. The average costs of all systems (including those that have not incurred the costs of upgrading) are by definition, lower than the costs of systems that have recently upgraded. Third, there are fundamental problems with the benchmarks themselves which further ensure that if operators who have undertaken a system upgrade are required to reduce their rates in accordance with the benchmark table, the resulting rates will be inadequate. The Commission should make adjustments to its formula that would take into account the costs of adding channels without requiring systems to invoke cost-of-service proceedings. The Joint Parties suggest adoption of an upgrade adjustment to counter the percentage reduction in per-channel rates mandated by the benchmark tables. The Commission should also apply its formula to adjust per-channel rates only with regard to the channels that are added, or, at most, to the tiers to which channels are added.

Approaches to Justifying Regulated Service Rates. The Commission should allow operators to choose different rate-setting methods for basic and non-basic services. Any concerns the Commission may have about "gaming" could be eliminated by allowing the Commission to consider the system's overall costs and rates for all regulated services. Requiring duplicative cost of service showings would unnecessarily increase the costs and burdens on all parties involved. The Commission should reject suggestions that it defer completely to the cost of service findings made by local franchising authorities.

Systems That Were Recently Upgraded. At a minimum, the Commission should allow systems that recently underwent an upgrade to raise their rates to benchmark levels. The general rationale for not allowing systems to raise their rates to the benchmark -- that existing rates must by definition be adequate to cover costs plus a reasonable profit -- falls apart when applied to systems that have recently undertaken an upgrade. These systems incurred costs they expected to recover over time with rates that would increase by more than the rate of inflation.

Benchmark rates, however, are rarely adequate to compensate operators who have recently upgraded their systems, and such operators' rates should not be capped at benchmark levels. The Commission should allow operators who have recently upgraded, as well as systems that wish to upgrade in the future, to apply the same channel addition formula.

Upgrades Required by Franchising Authorities. The Commission's proposal to permit external cost treatment for the costs of upgrades required by local franchising authorities is appropriate and consistent with the Commission's treatment of other franchise imposed costs. Indeed, there is no reason for limiting pass-throughs of upgrade costs to those approved by franchise authorities. Linking franchise authority approval to rate increases could deter upgrades and channel additions. Pass-throughs should therefore be allowed for appropriate costs whether or not they are required by franchising authorities.

The Commission should reject suggestions that recovery of upgrade costs be possible only through a cost of service showing. Such a rule would subject operators to expensive and burdensome cost of service showings merely because they wish to comply with their franchise requirements.

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REPLY COMMENTS

The Parties listed in the attached Exhibit A (the "Joint Parties"), by their attorneys, hereby submit their reply comments on the Commission's Third Further Notice of Proposed Rulemaking in the above captioned proceeding.[1/]

I. The Commission's Proposed Formula Must Be Modified to Provide Operators Reasonable Incentives to Add Channels to Existing Systems.

In this proceeding, the Commission is considering how, under its benchmark and price cap approach to rate regulation, to adjust maximum permissible rates when a cable system upgrades or otherwise adds channels to its regulated tiers. The Commission has offered several proposals for

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1/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Third Further Notice of Proposed Rulemaking, MM Dkt. 92-266, FCC 93-428 (released August 27, 1993)("Third Notice").

adjusting rates in such circumstances. It proposes that, under certain conditions -- specifically, when an upgrade is <u>required</u> by a franchising authority -- systems be allowed to pass through the costs of upgrades. And, in general, it proposes that when systems add channels, they adjust their maximum permissible per-channel rate by the percentage difference between the benchmark rate for systems with the initial number of channels and the benchmark rate for systems with the new number of channels.

In our initial comments, we argued that using the benchmark tables to adjust overall per-channel rates would result in rates too low to enable systems to recover their costs plus a reasonable profit after adding channels. Therefore, some combination of pass-throughs of upgrade costs and/or adjustments to the benchmark reductions would be necessary to provide adequate incentives to add channels.[2/] Some commenting parties --- principally, local franchising authorities -- disagree. They argue that there is no need for pass-throughs or adjustments to benchmark

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2/ As noted by the New York State Commission on Cable Television ("NYSCCT") operators could also be deterred from adding channels by notice requirements that could be triggered by rate increases due to channel additions. The Joint Parties agree with NYSCCT that the Commission should clarify that franchise authorities cannot use Section 76.933(b) to delay channel additions for up to four months. Comments of NYSCCT at 5.

reductions because "the benchmarks already incorporate costs of upgrades."[3/]

While it is true that the benchmark tables are based on rates of a random sample of systems, some of which undoubtedly had recently incurred upgrade expenses, this does not mean that the benchmark rates adequately provide for a recovery of upgrade costs plus a reasonable profit. First, the rates charged by systems on September 30, 1992 -- i.e., the rates reported in the survey -- were not established with the knowledge or expectation that future increases would be limited to the rate of inflation. As we explained in our initial comments, systems that upgrade their channel offerings do not typically increase rates immediately to a level that would enable them, on a going forward basis, to recover their upgrade costs. Instead, they generally increase their rates after an upgrade more gradually and periodically, at rates that necessarily exceed inflation.

What this means is that even if the benchmark rates were based solely on the rates of systems that had recently incurred upgrade expenses, those rates would be too low to enable systems that upgrade after the initial date of regulation (and are thus limited, on a going forward basis, to inflation-based rate increases) from ever fully

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3/ Comments of Austin, Texas, et al. ("Coalition") at 3.

recovering their costs plus a reasonable profit. Some upgrade adjustment or pass-through would be necessary simply to take into account the constraints of the newly imposed price caps.

Second, the benchmark rates are not, of course, based solely on the rates of recently upgraded systems. The Commission's random sample also includes older systems of varying channel capacities whose costs of construction may have been lower than those faced by current systems -- and whose costs, in any event, have been largely or fully depreciated. To the extent that benchmark rates are based on the predicted average rates of systems with comparable numbers of channels and subscribers, it is reasonable to assume that the costs (and, therefore, the rates) of recently upgraded systems would generally be above the average.

Austin, Texas et al. (the "Coalition") contend that "[t]here is certainly no reason to suppose upgrades require increases in rates to recover costs."[4/] Nobody, however, is suggesting that, as a general matter, maximum allowable per-channel rates should increase when a system adds channels.[5/] The question is whether they should decrease

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4/ Comments of Coalition at 3. (emphasis in original).

5/ In certain circumstances, however, -- where, for example, the costs of programming on the added channels far exceed the average costs of programming on existing channels (continued...)

to the full extent reflected in the benchmark tables. And the fact that the benchmarks are based on average rates while the rates and costs of recently upgraded systems are likely to be higher than those of the average system with a comparable number of channels indicates that some lesser reduction in allowable rates is warranted.

Third, there are fundamental problems with the Commission's benchmark scheme that, if left unadjusted, will seriously undermine the ability of operators to charge rates sufficient to recover the costs (plus a reasonable profit) of adding channels to regulated tiers. As a general matter, for various reasons identified in numerous petitions for reconsideration, the benchmarks are too low across the board. One such reason, for example, is that the benchmarks are based on average rates, even though half the systems subject to effective competition have rates higher than the average. Thus, systems that had the same costs -- and charged the same rates -- as comparable systems subject to effective competition would, under the benchmarks, nevertheless be subject to rate reductions.

Adjusting the benchmarks to correct such fundamental flaws is a task that the Commission should undertake on reconsideration of its Report and Order. But unless and

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5/ (...continued)
-- an increase in pre-channel rates could be warranted. Indeed, the Commission's proposal would authorize increases in such cases.

until such corrections are made, it is critical that the artificially low benchmarks not deter cable systems from upgrading and adding channels to their regulated tiers.

For all these reasons, the Commission should not simply require that systems that add channels reduce their per-channel rate for all regulated tiers by the percentage decline between the benchmark rate for the initial number of channels and the benchmark rate for the new number of channels. The Commission's proposed formula, as many parties have stated, represents a step in the right direction, because it at least exempts programming costs from the percentage reductions in maximum per-channel rates mandated by the benchmark tables.[6/] Whatever efficiencies

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6/ See, e.g., Comments of Viacom at 5-6. While the Coalition endorses the Commission's proposed formula as reasonable, the Local Governments oppose even this minimal adjustment to an approach that would reduce rates across the board by the percentage difference reflected in the benchmark tables. They complain that "[t]his method appears to be unduly complicated and would not be easy to administer." Comments of National Association of Telecommunications Officers and Advisors, et al. ("Local Governments") at 15. Exactly why the Commission's straightforward formula would be difficult to administer is unclear -- but if franchising authorities expect to have trouble applying this formula, it is difficult to imagine them responsibly reviewing cost-of-service proceedings.

The Local Governments support a formula based simply on the percentage reductions in the benchmark tables, but they offer a proposed adjustment of their own:

> [T]he Commission should develop a method to adjust such a new benchmark rate to account for rate adjustments made in the past as a result of external costs or a cost-of-service submission.

(continued...)

may result from upgrading and adding channels, there is no reason why programming should be expected to become less expensive, on a per-channel basis, merely because a system has added channels.

But this positive step is wholly inadequate to compensate systems for the costs of upgrading and adding channels. It recognizes that the supposed efficiency reduction embodied in the benchmarks should not apply to programming, but it does not recognize that the reduction, as it applies to the other costs of a system that has added channels, is still too large. The Coalition argues that allowing systems to pass through their upgrade costs "would be more complex than requiring a cost of service showing."[7/] But the Coalition offers no alternatives -- other than cost of service showings themselves -- for

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6/ (...continued)
For example, if the Commission, as a result of a cost-of-service submission, previously ordered a cable operator to reduce its rates to a rate below the then-permitted benchmark rate, the new benchmark rate should be adjusted to reflect such a rate reduction so that cable subscribers do not lose the benefit of such a rate reduction.

Id. at 16. This adjustment is no simpler than the one proposed by the Commission; the Local Governments evidently have much less difficulty understanding formulas when they *reduce* rates than when they increase them.

7/ Comments of Coalition at 4.

enabling systems to recover their costs plus a reasonable profit after adding channels.[8/]

We, and other commenting parties, offered several adjustments to the Commission's formula that would take into account the costs of adding channels without requiring all systems that add channels to invoke burdensome and time-consuming cost of service (or "mini" cost of service) proceedings. One was simply to adopt an "upgrade adjustment," which would counter, by some significant percentage, the percentage reduction in per-channel rates mandated by the benchmark tables. A second was to apply the Commission's formula only to the channels that are added, or, at most, to the tiers to which the channels are added. This approach, as we and other parties pointed out, would not only mitigate the excessive reductions required by the benchmark tables but would also avoid some of the undesirable effects of imposing rate reductions -- and

8/ The Coalition also suggests that operators might evade the one-year limitation on pass-throughs of retransmission consent fees by helping broadcasters launch new channels rather than paying cash compensation. Comments of Coalition at 9. The Coalition's concern is unwarranted because, unlike cash payments where the operator bargains for the right to air the station's signal, payments for new programming represent a separate, bargained-for exchange. Only if it were demonstrated that the amount paid for the new programming exceeded its fair market price could it even conceivably be argued that the amount in excess of the fair market price represented the equivalent of a retransmission consent fee.

increases -- on subscribers who do not even subscribe to the tiers to which channels are added or deleted.[9]

Finally, we argued that the Commission's proposed formula did not even fully account for the increased programming costs of adding channels. While the formula exempts programming costs from any efficiency reduction mandated by the benchmark tables, it does not exempt, as it should, the reasonable profits on such programming. Several parties agree that, unless such profits are also removed at the outset and added back at the conclusion of the calculations under the formula, systems that add channels will inappropriately be subjected to continually decreasing profit margins on their sale of programming.[10]

By adopting these measures, the Commission can facilitate the growth and development of cable systems and the addition of new channels to regulated tiers while still restraining the rates that may be charged for such tiers. Such adjustments will not, to be sure, result in precisely the correct "competitive" rate in every instance. But neither will cost of service regulation, especially to the

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9/ "Limiting the adjustment to the modified tier is essential to avoid rate changes for the universal basic service tier whenever programming is added or deleted on any other regulated tier." Comments of Liberty Media at 4. See also Comments of NCTA at 4-7; Comments of Community Antenna Television Association at 2; Comments of TCI at 2; Comments of Time Warner at 4; Comments of Falcon Cable TV, et al. at 7.

10/ See, e.g., Comments of Viacom at 9.

extent that it is applied by local entities lacking sufficient experience and expertise, particularly in the absence of well-developed standards. And if anything is certain, it is that the benchmarks themselves are, at best, grossly imprecise and imperfect approximations of what systems would charge if they were subject to effective competition.

In these circumstances, where there is a strong likelihood that reducing per-channel rates on all regulated tiers by the percentage reduction reflected in the benchmark tables will fail to provide adequate compensation for adding channels, the Commission should adopt simple adjustments that enable and encourage systems to upgrade their systems and add channels without having to invoke and endure cost of service regulation.

II. The Commission Should Not Prohibit Systems that Rely on a Cost-of-Service Showing to Justify Rates on One Regulated Tier From Relying on Benchmarks to Justify Rates on Other Tiers.

Several municipalities support the Commission's proposal that operators use the same rate-setting method for all regulated service tiers. They echo the Commission's concern that such an approach is necessary to avoid "gaming" by cable operators, noting specifically that an operator might "lump its more expensive cost elements into the tier that it chooses to have cost-based and its less expensive elements into the tier it chooses to have benchmarked." [11/]

As we discussed in our initial comments, however, allowing the Commission to consider the system's overall costs and rates for all regulated services (including the costs and rates for the basic tier) in making a cost of service determination for any non-basic tier of cable programming services should eliminate any concern about "gaming" by cable operators. Nowhere is it suggested that the Commission must make a cost of service determination for cable programming in a vacuum. In fact, the 1992 Cable Act specifically grants the Commission the authority to consider rates for all regulated cable services provided by the operator.[12/] And, by doing so, the Commission would prevent systems that relied on benchmarks to justify basic rates from reaping excessive profits where such rates substantially exceeded their costs associated with basic service.

Once these concerns regarding "gaming" are allayed, there is no remaining reason even to consider requiring a unitary regulatory selection -- and there are strong reasons not to do so. Requiring duplicative proceedings would unnecessarily double the costs and burdens of cost of

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11/ Comments of Municipal Franchising Authorities at 3-4; see also, Comments of Local Governments at 11; Comments of Coalition at 9-10.

12/ 47 U.S.C. § 543(c)(2)(D).

service showings whenever the overall rates allowed by the benchmarks were too low. It would force franchising authorities -- which unlike the Commission, would otherwise be able to avoid coming to grips with the intricacies of cost of service regulation altogether -- to devote considerable resources to reviewing basic rates that are no higher than the average rates charged by systems subject to effective competition. It would also introduce an additional degree of uncertainty and unpredictability to the cable operator's determination as to what rates may be charged for particular tiers.

Even if the Commission were unwilling to undertake a review of rates and costs of the basic tier when assessing whether rates for cable programming services were unreasonable, there would still be no reason to <u>require</u> a cost of service showing on both tiers in order to deal with the possibility of "gaming". The Commission could always rely, in particularly troublesome cases, on its authority to prevent "evasions". Or it could, as the Massachusetts Community Antenna Television Commission suggests, require systems that opt for cost of service on the non-basic tier to submit their basic rates to cost of service review by the local franchising authority, if the franchising authority suspected a problem, while allowing the franchising authority to approve rates at or below benchmark or permitted rate levels where it saw no need for cost of service review.[13]

To the extent that duplicative cost of service proceedings are ultimately required, some coordination between the Commission and the franchise authority may be required to minimize the costs and burdens of two showings and to prevent the cable operator from being whip-sawed by inconsistent determinations. But if there is to be such coordination, the Coalition's proposal -- that the Commission defer to and rely substantially on the franchising authority's cost of service determinations -- is the least acceptable.[14]

The Commission has experience and expertise regarding cost of service regulation and will be developing further expertise as it reviews complaints regarding cable programming service rates. Many local franchising authorities, in contrast, have little or no experience with the complexities of cost of service regulation,[15] and, except with respect to the operators in their specific franchise areas, they will have no opportunity to develop such experience. Furthermore, as the history of local rate regulation made clear before Congress largely prohibited

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13/ Comments of Massachusetts Community Antenna Television Association at 7.

14/ Comments of Coalition at 11.

15/ *See* Comments of Cable Operators and Associations at 9.

such regulation in 1984, local franchising authorities have strong political pressures to keep rates low and little incentive to consider the long term financial consequences of their decisions. Finally, complete deference to local authorities would violate Congress' statutory scheme, which grants the Commission exclusive authority over cable programming services.[16/]

III. Systems That Upgraded Shortly Before Congress Imposed Regulation Should Be Permitted to Adjust Rates in the Same Manner As Systems That Upgrade in the Future.

The Coalition asserts that "there is no rational basis for giving special treatment to recently upgraded systems" by allowing them to increase rates to benchmark levels.[17/] The rationale given by the Commission for not generally allowing systems with rates below benchmark levels to raise their rates to such levels was that such systems' existing rates must, by definition, be adequate to cover costs plus a reasonable profit. This rationale falls apart when applied to systems that have recently undertaken an upgrade. As discussed in Part I, <u>supra</u>, such systems have incurred costs that they generally expected to recover over time with rates that increased by more than the rate of inflation. Rates below benchmark levels could not have been sustained by such systems and would not have been retained had they known that

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16/ <u>Id.</u>

17/ Comments of Coalition at 7.

their future rate increases would be limited to the rate of inflation.

Having changed expectations by so limiting future rate increases, the Commission should, at a minimum, allow those systems to charge benchmark rates. The Commission, in establishing its benchmarks, determined that benchmark rates were presumptively reasonable. Indeed, it has not even required all systems with rates above benchmark levels to reduce their rates fully to those levels. There can be little harm, therefore, in allowing systems that have recently upgraded to charge no more than benchmark rates.

The problem is, however, that benchmark rates may not be sufficient to compensate all operators who have recently undergone system upgrades.[18/] There is no basis for limiting the rates of recently upgraded systems to benchmark rates if those rates will not allow them to recover the cost of an upgrade. Rather, the Commission should allow operators who have recently upgraded, or systems that wish to upgrade in the future, to apply the same channel addition formula that is to be used, on a going forward basis, by systems that add channels in the future.

18/ Comments of Joint Parties at 14-15.

IV. Operators Should Be Permitted to Pass Through Costs of Upgrades Required By Local Franchising Authorities or Other Regulatory Authorities.

The Commission solicited comment on whether it should permit external cost treatment for costs of upgrades required by local franchising authorities.[19] Such a rule would be consistent with the Commission's treatment of other franchise-imposed costs.[20] The Coalition asserts, however, that operators have control over upgrade costs because the franchise requirement is typically the result of mutual agreement between the operator and the franchising authority, and that such costs, therefore, should not be treated as "external".[21] But this argument misses the

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19/ Third Notice at ¶ 153.

20/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report and Order, MM Dkt. 92-266, FCC 93-177 ¶ 254 (released May 3, 1993)("Rate Order"); Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, First Order On Reconsideration, MM Dkt. No. 92-266, n.160 (released August 27, 1993)("Reconsideration Order").

21/ Comments of Coalition at 2. Local Governments similarly suggest that there should be no pass-throughs for any upgrade costs and that such costs should be recoverable only through a cost of service showing. Comments of Local Governments at 8. But Local Governments argue that, even in cost-of-service proceedings, upgrade costs should be recoverable only if strict threshold requirements are met. In the case of franchise-imposed upgrades, such a rule has the potential to subject operators to the expense and administrative burden of a cost of service showing merely to allow it to comply with its contractual obligations under the franchise. If threshold requirements are implemented, operators may be denied any avenue to recover the expense of a mandatory upgrade. Voluntary upgrades by cable operators

(continued...)

point. The only reason for limiting pass-throughs of costs to those costs not wholly within the operator's control is to prevent systems from making unnecessary and useless expenditures for which subscribers should not have to pay. But where a franchising authority endorses and requires such expenditures -- whether unilaterally or by agreement -- it has essentially determined that the expenditures <u>should</u> be incurred.[22/]

Indeed, there is no reason to suspect that <u>any</u> upgrades by cable systems should be deemed by subscribers to be useless or undesirable, especially given the constantly expanding supply, demand and technological availability of new and improved services.[23/] In these circumstances, there is no reason for limiting pass-throughs of upgrade costs to those required by franchising authorities. Indeed,

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<u>21/</u> (...continued)
may be discouraged altogether by the adoption of such harsh rules. Such a result would be to the detriment of the system, its subscribers and the franchise.

<u>22/</u> In any event, not all franchise-imposed upgrade costs are the result of mutual agreement. In some instances, franchising authorities may, indeed, impose upgrade requirements that the cable operator would view as inappropriate or unnecessary.

<u>23/</u> <u>See</u> Comments of NYSCCT at 5. ("[W]hether or not a recent or current upgrade was completed or commenced in fulfillment of a specific franchise condition, . . . it is fair to presume that increased capacity and enhanced technological features are potentially beneficial to the franchise area and, therefore, that local authority over adjustments to rates based on the cost of an upgrade should essentially be the same as if the upgrade was required by the franchise").

linking franchise authority approval of upgrades to recovery of upgrade costs through rate increases is likely to have the undesirable effect of deterring upgrades and channel additions.

Thus, the Coalition argues that allowing pass-throughs for franchise- imposed upgrade costs would "effectively punish franchising authorities that diligently carry out their obligations by eliciting a binding promise from the operator to make system improvements."[24/] These franchising authorities seem to view rate increases that are necessary to pay for upgrades as a "bad" thing, even when they demand or agree to the upgrades. If pass-throughs are limited to cases where the franchising authority requires or agrees to the upgrades, franchising authorities may seek to avoid the "punishment" of rate increases by refusing to require upgrades. As a result there will be fewer upgrades undertaken by cable operators, because they have no way to pay for them. This result is clearly contrary to Congressional intent and sound public policy.

A better approach would be to allow pass-throughs for appropriate upgrade costs, whether or not they are required by franchising authorities. To the extent that operators impose additional costs, operators need to recoup these costs regardless of whether they've been imposed by the

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24/ Comments of Coalition at 2. (emphasis added).

franchising authority or not. There is no reason for allowing franchising authorities to exercise a veto over the ability of systems to grow and adapt to new technologies.

CONCLUSION

For the foregoing reasons and for the reasons set forth in our initial comments, the Commission should adopt an approach that ensures that a system that adds channels will be able to charge rates that allow recovery of its costs plus a reasonable profit. Such an approach will require various adjustments, as described herein, to the Commission's proposed benchmark-based formula, as well as pass-throughs of certain upgrade costs. Finally, the Commission should reject its proposal that systems be required to use the same approach -- benchmarks or cost of service -- to justify basic rates and rates for cable programming services.

Respectfully submitted,

JOINT PARTIES

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EXHIBIT A

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